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Attorneys for Rio Rico Utilities, Inc.

**BEFORE THE ARIZONA CORPORATION COMMISSION**

IN THE MATTER OF THE  
APPLICATION OF RIO RICO  
UTILITIES, INC., AN ARIZONA  
CORPORATION, FOR A  
DETERMINATION OF THE FAIR  
VALUE OF ITS UTILITY PLANTS AND  
PROPERTY AND FOR INCREASES IN  
ITS WATER AND WASTEWATER  
RATES AND CHARGES FOR UTILITY  
SERVICE BASED THEREON.

DOCKET NO: WS-02676A-12-0196

**NOTICE OF FILING WITNESS  
SUMMARIES**

Rio Rico Utilities, Inc. ("RRUI" or the "Company") hereby submits this Notice of Filing in the above-referenced matter. Specifically filed herewith are the summaries of the pre-filed testimony of the following witnesses:

1. Gregory S. Sorensen;
2. Christopher Krygier; and
3. Thomas J. Bourassa.

DATED this 25<sup>TH</sup> day of March, 2013.

FENNEMORE CRAIG, P.C.

Arizona Corporation Commission

**DOCKETED**

MAR 25 2013

DOCKETED BY

*JSN*

By: 

Jay L. Shapiro  
Attorney for Rio Rico Utilities, Inc.

1 **ORIGINAL** and 13 copies filed  
2 this 25th day of March, 2013 with:  
3 Docket Control  
4 Arizona Corporation Commission  
5 1200 West Washington Street  
6 Phoenix, Arizona 85007  
7 **COPY** of the foregoing was emailed/mailed  
8 this 25th day of March, 2013 to:  
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**Rio Rico Utilities, Inc. dba Liberty Utilities**  
**WS-02676A-12-0196**

**Gregory S. Sorensen**  
**Summary of Prefiled Testimony**

Mr. Sorensen is employed by Liberty Utilities as Vice President and General Manager. Liberty Utilities manages and operates utilities in Arizona, Texas, Missouri, and Illinois. In Arizona, Mr. Sorensen is responsible for the daily operations and administration of all the utilities, including RRUI, for the financial and operating results for each utility, for capital and operating cost budgeting, for rate case planning and oversight, and for rate setting policies and procedures. He also oversees customer and development services, human resources, engineering and conservation planning. Mr. Sorensen has testified in Commission proceeding for all of Liberty Utilities' affiliate entities, including several rates cases.

Mr. Sorensen prefiled direct, rebuttal, and rejoinder testimony in support of RRUI's application for rate relief. In his direct testimony, he provided background on RRUI and its operations, and summarized the significant capital improvements and other operating cost changes since the last rate case. He also addressed certain aspects of the relief being requested, including approval of certain changes to RRUI's tariff of rates and charges for water and wastewater service.

In his rebuttal and rejoinder testimonies, Mr. Sorensen responded to testimony by Staff and RUCO regarding RRUI's policies on bonuses, merit pay, and benefits.

Specifically, among other things, Mr. Sorensen will testify that:

- RRUI is in compliance with ADEQ, ADWR, ADOR, and ACC rules and regulations.
- RRUI purchased a new building for its offices, rehabilitated a 28-year old water plant, and paid approximately \$2 million for upgraded treatment capacity and a new agreement with the City of Nogales. RRUI also made ongoing investment to improve the water distribution and wastewater collection system and service lines.
- Since the last test year RRUI made the following significant cost savings changes: 1) in mid-2010 replacement of leaking service lines; 2) expanded use of SCADA for well control; 3) installation of automated enzyme feeding system; and 4) change in service disconnect program for non-payments.

- Since the last rate case RRUI has worked to address non-revenue water by changing the procedures on service and fully replacing service lines. RRUI has furthered conservation efforts by committing to ten Best Management Practices and complying with the resultant ADWR and ACC requirements.
- “Merit pay” is an important recruiting tool for Liberty Utilities. Merit increases are not achievement or incentive pay. Merit pay is simply a way to arrive at what hourly or annual pay rate the employee will be paid during the coming year based on where that employee’s pay currently rests and how well the employee performed during the prior year. Merit pay is not shared with the shareholder.
- “Incentive pay” is also an important recruiting tool. Bonuses or incentive programs are part of an employee’s overall or total compensation. Total compensation has to be market competitive otherwise employees will not stay, the turnover rate will be higher, and service to the customer will suffer. Incentive pay is known, measurable, and incurred during the test year. Incentive pay is not shared with the shareholder.
- Liberty Utilities has standardized its benefits program across all of its United States water, sewer, gas, and electric utilities. Consequently, there was a change to RRUI’s program expenses. Approximately 75 percent of the adjustment relates to employees directly working in RRUI. The other 25 percent relates to employees based in the corporate office providing administrative support to RRUI, similar to other employee costs.

**Rio Rico Utilities, Inc. dba Liberty Utilities**  
**WS-02676A-12-0196**

**Chris Krygier**  
**Summary of Prefiled Testimony**

Mr. Krygier is employed by Liberty Utilities as the Utility Rates and Regulatory Manager. Liberty Utilities is the same entity as Liberty Water, the name the company has operated under in Arizona the past several years. Liberty Utilities manages and operates water and sewer utilities in Arizona, Texas, Missouri, Arkansas and Illinois. Mr. Krygier is responsible for the water and wastewater rate cases and public utility regulation in Arizona, Texas, Missouri and Arkansas. He has not previously testified before the ACC; however, he has provided written testimony in Docket 2010-0313 before the Hawaii Public Utilities Commission.

Mr. Krygier will adopt the prefiled testimony of Peter Eichler and will testify regarding the cost allocation procedures used by RRUI's ultimate parent company, Algonquin Power & Utilities Corp. ("APUC") to allocate shared costs between all of its subsidiary and affiliated companies, including Liberty Utilities and its operating utility subsidiaries.<sup>1</sup> Mr. Krygier's testimony details the costs included in the cost allocations from APUC, states the reasons the costs are necessary, and identifies the significant benefits to RRUI's customers as being part of Liberty Utilities and the APUC corporate family.

Mr. Krygier's testimony explains that APUC incurs four major types of cost categories in its allocated cost pool, APUC Strategic Management Costs, Access to Capital Markets Costs, APUC Financial Controls and APUC Administrative Costs. The APUC Strategic Management cost category includes Board of Directors Fees, General Legal Services and Professional Services. The Access to Capital Markets Costs includes License and Permit Fees, Escrow Fees, Unitholder Communications. The APUC

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<sup>1</sup> Mr. Krygier also prefiled his direct, rebuttal and rejoinder testimony in this rate case. In his direct testimony, he testified in support of RRUI's request for ACC approval of a Sustainable Water Loss Improvement Program ("SWIP"). In his rebuttal testimony, Mr. Krygier addressed Staff's System Betterment Cost Recovery mechanism ("SBCR"), the SWIP raised in his direct testimony, and the Distribution System Improvement Charge ("DSIC"). His rejoinder testimony addressed RRUI's request for approval of a DSIC and Collection System Improvement Charge ("CSIC"). However, as discussed at the procedural conference on the March 21, 2013, RRUI is no longer requesting approval of any DSIC-like mechanisms in this case.

Financial Controls costs include Audit Fees and Tax Services. Further detail of these costs is included in Exhibit PE – DT2, Appendix 2 of Mr. Eichler’s Direct Testimony. Finally, in detailing what types of costs are incurred, Liberty Utilities performed an analysis to determine the reasonableness for the types of costs incurred. Attached as Exhibit PE – DT1, the Company analyzed a number of different benchmark measures to ensure that the costs incurred by APUC are in line with other utilities the Company is often compared to. First, the Company analyzed if RRUI would incur the same types of costs if it were a standalone publicly traded company on the Toronto Stock Exchange or New York Stock Exchange and the answer is yes. RRUI would be subject to all of the same legal requirements of being publicly traded regardless of the size of the company. Additionally, services like computer system maintenance, benefits consulting and the like would still be necessary for any company that was publicly traded. Next, RRUI compared its costs to Arizona regulated utilities Arizona Public Service, UNS Gas, UNS Electric, Global Water and Arizona-American Water Company (now EPCOR). RRUI determined that other Arizona regulated utilities incur the same exact cost types as being a publicly traded entity on the New York Stock Exchange. Finally, to ensure its analysis was reasonable, RRUI compared its costs to the cost of capital proxy group used by RUCO and Staff in their return on equity analysis. RRUI determined that water and gas cost of capital proxy group’s used by RUCO and Staff incurred the same exact costs as APUC. After completing this analysis RRUI concluded that in general, Staff and RUCO allow these exact costs for other Arizona regulated utilities but not RRUI and the other Liberty Utilities’ entities.

Mr. Krygier’s testimony also describes the allocation methodology. Once a cost is incurred at the APUC level it starts a detailed procedure of how that cost is allocated down to RRUI (or other Liberty utilities). A simple illustration of the process is attached to the prefiled testimony, Exhibit PE – DT2 (Cost Allocation Manual), Appendix 3 – Life of an Invoice. This visual illustration walks readers through how an invoice is treated from cost incurrence to allocation to the utilities. The first step in the process after the invoice is received is to determine if the invoice can be directly charged. This direct charging could be to one of three major categories, a subsidiary of Liberty Utilities (RRUI as an example), a subsidiary of Algonquin Power Company (APCO on the chart), or third, shareholders can pay for the expense. Examples of shareholders paying the expense include charitable donations and corporate travel programs. If an expense cannot be directly charged to a subsidiary or paid for by the shareholder, it moves into the allocation pool, the right hand side of the visual illustration. As a general practice Liberty completes this process on a monthly basis and provided extensive detail of the underlying support to Staff and RUCO through the discovery process.

Mr. Krygier’s testimony also focuses on the benefits that accrue through the cost allocation. One significant benefit is economies of scale. As a nearly \$3 billion asset company, APUC is able to drive pricing that is cheaper than RRUI could on its own. An example is audit services. If RRUI were a standalone publicly traded entity it would be



required to hire external auditors to provide detailed financial reports on its books and records. As part of APUC, RRUI's audit requirements are wrapped into the larger corporate audit completed by external auditors saving RRUI money. RRUI also benefits from access to capital markets. RRUI would be too small on its own to access the capital markets.

The importance of this access to capital markets is plainly evident in this rate case. RRUI successfully sourced capital to fund three major capital projects (in addition to numerous smaller projects) worth over \$2 million dollars. The three projects, a water plant rehabilitation, an office building purchase, and a payment for wastewater treatment plant upgrades were critically important to ensure the continued provision of safe and reliable utility service to its customers. The success of that service can be seen in its metrics Mr. Sorensen discusses with the customer satisfaction survey in his Direct Testimony.

**Rio Rico Utilities, Inc. dba Liberty Utilities**  
**WS-02676A-12-0196**

**Thomas J. Bourassa**  
**Summary of Prefiled Testimony**

Thomas J. Bourassa is a Certified Public Accountant who provides consulting services to public utilities. He has testified on numerous occasions before the Arizona Corporation Commission (the "Commission") on behalf of Arizona water and wastewater utilities. In this rate case he is testifying on behalf of Rio Rico Utilities, Inc. (the "Company") on the topics of the Company's rate base, its income statement (i.e., revenue and operating expenses), its required increase in revenue, and its rate design and proposed rates and charges for service. Mr. Bourassa is also testifying on the cost of capital, including the cost of equity.

**Overview of the Company's Requested Rate Relief**

The Company is requesting a gross revenue increase of \$644,939 for its water division, which is an increase of approximately 23.13 percent over test year (December 31, 2008) revenues, and an increase of \$279,532 for its wastewater division, which is an increase of approximately 20.40 percent over test year (December 31, 2008) revenues. The following is a summary of the Company's water and wastewater division revenue requirement:

	<u>Water</u>	<u>Wastewater</u>
Fair Value Rate Base	\$7,730,108	\$4,735,192
Adjusted Operating Income	\$ 345,590	\$ 281,341
Current Rate of Return	4.47%	5.94%
Required Operating Income	\$ 734,360	\$ 449,843
Required Rate of Return	9.50%	9.50%
Operating Income Deficiency	\$ 388,770	\$ 168,502
Gross Revenue Conversion Factor	1.6589	1.6589
Increase in Gross Revenues	\$ 644,939	\$ 279,532

Under the Company's proposed rates for the water division a typical  $\frac{3}{4}$  inch metered residential customer would experience an increase of \$7.77 (about 26.13 percent), from \$29.75 per month to \$37.52 per month.

Under the Company's proposed rates for the wastewater division, a typical residential customer would experience an increase of \$9.77 (about 21.30 percent), from \$45.88 per month to \$55.65 per month.

The following is a brief summary of the major unresolved issues about which Mr. Bourassa will testify.

### **Rate Base Issues - Water**

The dispute between the parties regarding the plant-in-service (PIS), accumulated depreciation (A/D), net contributions-in-aid of construction (net CIAC) and accumulated deferred income taxes (ADIT) revolves around the approach that each of the parties' takes in addressing an overstatement in A/D and depreciation expense; particularly with respect to pumping equipment and miscellaneous equipment. The Company proposes retirements to pumping equipment and miscellaneous equipment so that computed depreciation using the asset group method in the intervening years since the last test year is lower due to the fact that the PIS balance upon which the depreciation rate is applied is lower. The Company approach reduces the PIS balance along with the A/D balance. The Company approach also increases the net CIAC balance and increases the ADIT balance. The Company believes that its approach is warranted under the circumstances and is the most comprehensive approach as it recognizes that past retirements have not been recorded and resolves longer-term issues with respect to A/D and depreciation expense.

Staff does not propose retirements but rather separates the pumping equipment account and miscellaneous equipment balances into vintage year groups and ceases depreciating certain vintage year groups when the group becomes fully depreciated. Like the Company approach, computed depreciation in the intervening years since the last test year is lower due to the fact that the fully depreciated pumping equipment and miscellaneous equipment vintage year groups are excluded from the depreciation calculations. However, the Staff approach does not reduce the PIS balance, it only reduces the A/D balance. The Staff approach also increases the net CIAC balance and increases the ADIT balance, like the Company does. The main difference between the Company and the Staff approaches is that the PIS balance is reduced under the Company approach whereas it is not reduced under the Staff approach. The Staff approach also utilizes a different depreciation methodology (vintage year group vs. asset group) for the pumping equipment and miscellaneous equipment PIS accounts whereas it employs an asset group method on the rest of the PIS accounts. The Company consistently uses the asset group method for all PIS accounts.

RUCO also does not propose retirements but proposes an unorthodox method of computing depreciation in the intervening years which RUCO claims recognizes fully depreciated PIS. RUCO computes depreciation using the net book balance rather than the gross PIS balances, unlike any accepted depreciation method. That said, like the Company approach, computed depreciation in the intervening years since the last test

year is lower. The RUCO approach does not reduce the PIS balance, but, like the Company, RUCO does reduce the A/D balance. The RUCO approach also increases the net CIAC balance and increases the ADIT balance like the Company does. The RUCO approach also differs from both the Company and the Staff approaches in the depreciation methodologies employed.

### **Rate Base Issues – Wastewater**

The dispute between the parties regarding the plant-in-service (PIS), accumulated depreciation (A/D), net contributions-in-aid of construction (net CIAC), and accumulated deferred income taxes (ADIT) revolves around the approach to each of the parties takes in addressing this issue of an overstatement in A/D and depreciation expense, particularly with respect to pumping equipment. How each of the parties address this issue is described above for the water division and applies equally to the wastewater system.

### **Revenue and Income Statement Issues – Water Division**

1. Depreciation – The differences in each of the parties' recommended depreciation expense levels are the result of each party's recommended depreciable PIS balances. The differences in the depreciable PIS balances stem from the respective approaches to resolving the overstatement in the A/D balance described above.
2. Declining Usage Adjustment – The Company proposes a declining usage adjustment to reflect expected revenue erosion in the future from the conservation rates proposed by the Company. Both Staff and RUCO disagree with the Company proposed adjustment.
3. Morning Star Ranch (MSR) revenue annualization – The Company and RUCO are in agreement on the revenue annualization for MSR. Staff proposes a somewhat lower revenue annualization amount.
4. Corporate Allocation – Both Staff and RUCO propose reductions to the corporate allocation, albeit for different amounts and for different reasons. The Company disagrees with the recommendations of Staff and RUCO.
5. Achievement and Incentive Pay – The Company disagrees with the RUCO recommendation to disallow certain achievement and incentive pay from test year operating expenses.
6. Employee Benefits – The Company and RUCO agree on the Company recommended adjustment to employee benefits based on a change in the Company's benefit plan. RUCO has provisionally adopted the Company's adjustment and needs to further evaluate. Staff has rejected the Company's recommendation.

7. Rate Case Expense – All of the parties agree to rate case expense of \$262,500. The Company and Staff propose a 3 year amortization period, whereas RUCO propose a 4-year amortization period.
8. Purchased Power – The Company and Staff agree on the Company's recommendation to increase purchased power for the anticipated increase in UNS Electric's rates. Staff recommends the increase reflect the amounts approved in the UNS Electric rate case. RUCO rejects the Company's recommended increase.
9. Property Taxes – The Company and Staff agree on the property tax rates used in the modified ADOR formula for computing income taxes. RUCO proposes somewhat different property tax rates. The difference between the parties with respect to property taxes is due to the disagreement over the property tax rates employed.

#### **Revenue and Income Statement Issues – Wastewater Division**

1. Depreciation – The differences in each of the parties' recommended depreciation expense levels are the result of each of the party's recommend depreciable PIS balances. The differences in the depreciable PIS balances stem from the respective approaches to resolving the overstatement in the A/D balance described above.
2. Declining Usage Adjustment – The Company proposes a declining usage adjustment to reflect expected revenue erosion in the future from the conservation rates proposed by the Company. Both Staff and RUCO disagree with the Company proposed adjustment.
3. Corporate Allocation – Both Staff and RUCO propose reductions to the corporate allocation albeit for different amounts and for different reasons. The Company disagrees with the recommendations of Staff and RUCO.
4. Achievement and Incentive Pay – The Company disagrees with the RUCO recommendation to disallow certain achievement and incentive pay from test year operating expenses.
5. Employee Benefits – The Company and RUCO agree on the Company recommended adjustment to employee benefits based on a change in the Company's benefit plan. RUCO has provisionally adopted the Company's adjustment and needs to further evaluate. Staff has rejected the Company's recommendation.
6. Rate Case Expense – All of the parties agree to rate case expense of \$87,500. The Company and Staff propose a 3-year amortization period, whereas RUCO propose a 4-year amortization period.

7. Purchased Power – The Company and Staff agree on the Company's recommendation to increase purchased power for the anticipated increase in UNS Electric's rates. Staff recommends the increase reflect the amounts approved in the UNS Electric rate case. RUCO rejects the Company's recommended increase.
8. Property Taxes – The Company and Staff agree on the property tax rates used in the modified ADOR formula for computing income taxes. RUCO proposes somewhat different property tax rates. The difference between the parties with respect to property taxes is primarily due to the disagreement over the property tax rates employed.
9. Nogales Wastewater Treatment Expense – The Company does not agree with the RUCO recommendation to reduce test year wastewater treatment expense for the Nogales WW treatment expense as the level RUCO recommends is not a known and measurable going forward amount. The Company and RUCO agree that once the contractual amount for the City of Nogales is clarified, the wastewater treatment expense should be trued-up to the actual going-forward costs.

#### **Rate Design and Proposed Rates – Water Division**

The Company's recommended rate design places more emphasis on revenue recovery from the monthly minimums and the first tier commodity rates for the smaller metered residential customers to provide a better balance between conservation and revenue stability. Staff also places a greater emphasis on recovery from the monthly minimums but decreases the first tier commodity rates for the smaller metered customers to a level lower than these customers currently pay. The Company believes this not only sends the wrong price signal to customers but also increases revenue instability due to higher second and third tier commodity rates.

RUCO's rate design derives revenues from the monthly minimums in a manner similar to the Company's current rate design and far below the levels the Company and Staff propose.

#### **Rate Design and Proposed Rates – Wastewater Division**

The Company's rate design is the same basic rate design currently in effect, which primarily reflects a flat rate design for residential and commercial customers. The rate design does contain some charge per rated gallon per day features. Both Staff and RUCO propose rate designs similar to the Company.

#### **Cost of Equity and WACC**

Mr. Bourassa performed estimates of the cost of equity using the Commission's preferred models, the Discounted Cash Flow ("DCF") model, and the Capital Asset Pricing Model ("CAPM"). Mr. Bourassa's updated estimate of the cost of equity is 9.5

percent. The Company's unadjusted cost of equity is 9.9 percent. The Company proposes a 90 basis point reduction for financial risk and an 80 basis point increase for a small company risk premium. The Company's adjusted cost of equity is 9.8 percent, but the Company is recommending 9.5 percent to be conservative. The Company proposes a 0 percent debt and 100 percent equity capital structure. Accordingly, weighted cost of capital ("WACC") is 9.5 percent.

Staff recommends an 8.2 percent cost of equity. Staff recommends a WACC of 8.2 percent based on a 0 percent debt and 100 percent equity capital structure. Staff's unadjusted cost of equity is 8.5 percent. Staff proposes a 90 basis point reduction to the cost of equity for financial risk and then adds an economic assessment adjustment of 60 basis points.

RUCO proposes a WACC of 8.25 percent using a capital structure consisting of 0 percent debt and 100 percent equity. RUCO recommends a cost of equity of 8.25 percent. RUCO used different sample water utilities, eliminating Aqua America's which are used by both Staff and the Company, and added American Water Works. RUCO also used a group of publicly traded gas utilities.

The Company has compared the Staff and RUCO recommended returns on equity to the results using the build-up method based on market portfolios of various measures of firm size as well as a comparison of authorized returns and expected returns for the water utility sample companies. The comparisons show the Staff and RUCO recommendations are too low. Mr. Bourassa also shows the Company would not be able to pay the same level of dividends as the publicly traded water utilities under the Staff and RUCO recommendations. In other words, the Company would not be able to support its invested capital. In the Company's view, the Staff and RUCO recommended returns fall far short of the capital attraction standards set forth in *Federal Power Commission v. Hope Natural Gas Co.*, 320 U.S. 591, 603 (1944) and *Bluefield Water Works and Improvement Co. v. Public Service Commission of West Virginia*, 262 U.S. 679 (1923).